DOES THE ESTATE TAX REALLY AMOUNT TO DOUBLE TAXATION?

Laurence Blau and Vanessa Zurita-Rufer

Rep. Jason Chaffetz (R-Utah) once said it was immoral that we have an estate tax. He felt that since we tax people during their lifetimes, their families should not be taxed again after their death.[1]

But if you look at the interrelationship between the income tax and the wealth transfer tax—along with the fact that capital appreciation is often not taxed—the reality is a lot more complicated.

Let's analyze Chaffetz's statement with an example of a fictitious family. Suppose Donald inherits $1 million from his father, Fred. While Fred's estate would have estate tax consequences,[2] Donald can specifically exclude the $1 million from his gross income.[3] Thus, there is no double tax in this specific situation.

But is there a double tax after Donald receives his inheritance?

Assuming Donald has properly paid all his income taxes during his lifetime, then on his death, we need to look at the estate tax provisions for the taxability of Donald's estate. The value of his taxable estate will be determined by looking at the value of his property at the time of Donald's death.[4] But the estate tax and income tax systems do not tax the same thing. The income tax taxes income and the estate tax taxes property.[5] The income tax system does tax the income generated from property and the gain from the disposition of the property, but it does not tax the actual value of the property.[6] Therefore, there is no direct double tax in the federal tax system.

But is there an indirect double tax? The question of an indirect double tax depends on what kind of "property" is held at the person's death. For example, suppose a person's property consists solely of money in a bank account and all of that money was earned as wages (taxable income) during the person's lifetime. Then, that property would be taxed twice, once with an income tax on wages earned during the person's lifetime and a second time with an estate tax on that property upon the person's death.

Many years ago, when most people earned their income in the form of wages, that was usually the case when people died. However, the issue of what is property is much more complex today. Wealthy people do not just earn income on wages anymore. In fact, some of the biggest holdings of property in the U.S. are in the form of stocks and real estate.

While people do pay an income tax on their stock dividends and their rental income on real property—and would pay a

The question of an indirect double tax depends on what kind of "property" is held at the person's death.

capital gains tax if they directly sold their holdings—they do not pay an income tax on the property itself. There is no federal income tax on property or the appreciation of property until a person disposes of it. This means that the unrealized appreciation of property is not taxed under the federal income tax system during a person's lifetime unless there is a "triggering event."

Researchers at the Federal Reserve Board have estimated that the unrealized appreciation from all U.S. assets accounts for a significant portion of the property being transferred on death. It is estimated that this unrealized capital appreciation may range from 32 percent for estates worth between $5 million and $10 million to as much as about 55 percent of the value of estates worth more than $100 million.[7]

Because that unrealized appreciation is not taxed for income tax purposes under the tax code, we can estimate that around 32-55 percent of the value of all property held by wealthy decedents with estates worth over $5 million is unrealized capital appreciation. Without a triggering event, that wealth is not directly or indirectly taxed during a person's lifetime. This could mean that as much as 32-55 percent of the wealth in this country has not been taxed at all during a person's lifetime.

So even if someone did have an estate over the estate tax exempt amount (currently $11,180,000) and was subject to the estate tax, if these numbers are accurate we can deduce that indirectly only around 45-68 percent of the value of their property was actually taxed twice and 32-55 percent of the value of their property escaped double taxation.

To be fair, that also means that if someone was subject to the estate tax, then some of their property was taxed twice. Even if we do not have a direct double tax, our system does have an indirect double tax.

If Rep. Chaffetz's argument was based on the indirect taxation that is imposed on us during life and on death with the income and wealth transfer tax systems, then that argument does make sense. When we earn income to buy the property, we are taxed on that income and then the estate is potentially taxed again on that property when it passes at death. While this is a valid argument, we should go back to our example as it applies to Donald and his family and see how infrequently double taxation actually occurs.

Suppose Donald took that $1 million he inherited and bought a building in New York. Further suppose he wanted more property, so he borrowed money from the equity in the building and bought another building. Over the next few years, he obtained other buildings by borrowing or doing a 1031 exchange.[8] This way, Donald would be able to defer capital gains on his lifetime sales of appreciation property by calling these transactions "exchanges" under Section 1031.

Donald could continue these debt purchases and 1031 exchanges for the rest of his life because when he buys a building with borrowed money or does a 1031 exchange, there are no immediate income tax consequences. Further, the value of the buildings will presumably grow over time. While the rents, dividends, and distributions from the buildings have income tax consequences, he also enjoys favorable deprecation rules, which allow him to pay less income tax on the real estate distributions.

Further, under the tax code, when he dies it is not considered an income tax triggering event. In fact, there will be an income tax death benefit. When Donald passes away, the basis of all his assets steps up to fair market value at the time of his death, meaning no one will ever pay any income tax on the lifetime appreciation of the buildings.[9]

While Donald's property is subject to the estate tax, if his estate is going to his spouse and it qualifies for the marital deduction,[10] then his estate will not owe any estate tax at the time of his death. Further, when Donald's spouse inherits the property with a new higher basis, his spouse can start the same cycle he did, but now the basis in the buildings for depreciation purposes is the stepped-up basis (the fair market value on Donald's date of death[11]), which helps his spouse defer more income taxes. His spouse can potentially shield $22,360,000 (indexed for inflation) in property with the estate tax exemption.[12] If his spouse dies with an estate worth more than the exemption amount, the estate would be subject to the estate tax—but think of all the income tax benefits received during the spouse's lifetime.

In this example, Donald's property was not subject to a double taxation. In 2018, if a person has over $11,180,000 (or $22,360,000 for a married couple), there will be some situations where a percentage of their assets will be taxed twice. But is it really immoral to tax this money again? It is a bit simplistic to say that. Most transactions we conduct on a daily basis are taxed multiple times. If we buy something at a store, we pay a sales tax, the owner pays income tax on the profit, maybe a payroll tax and pays a tax to different levels of the government (federal, state, and local governments).

Further, if a person is not over the estate tax exempt amount, there are no situations where the family will pay a double tax. In fact, often they are not paying even one full tax because the unrealized capital appreciation is escaping taxation.

The economy has changed a lot in the last century. Today, wealthy people do not earn money just from wages. There is a lot of capital appreciation in their assets. Unfortunately, we are still hearing comments either based on the old economy or untrue political statements. While Rep. Chaffetz's statement had merit many years ago, it is simply not true today.

Laurence Blau is a sole practitioner in San Francisco and adjunct professor of law at the University of San Francisco School of Law and UC Hastings College of the Law. Vanessa Zurita-Rufer is a third-year law student at UC Hastings College of the Law. The views expressed here are solely the opinion of the authors and do not reflect their respective schools.

Notes:

1. www.huffingtonpost.com/2015/01/21/wealth-tax_n_6512848.html.
2. See I.R.C. § 2001-2002.
3. See I.R.C. § 102(a), gross income does not include the value of property acquired by gift, devise, or inheritance.
4. See I.R.C. § 2031.
5. Sometimes our "property" is directly "taxed" during our lifetime as States do have a "property tax" on real property. Some jurisdictions also have a tax on the value of your property like a business personal property tax. Thus, there is some form of direct double taxation. However, here we are focusing on the federal tax system.
6. See I.R.C. §§ 61 and 61(a)(3).
7. See Avery, Grodzicki, and Moore (2013). "Estate vs. Capital Gains Taxation: An Evaluation of Prospective Policies for Taxing Wealth at the Time of Death," Finance and Economics Discussion Series 2013-28. Washington: Board of Governors of the Federal Reserve System, www.federalreserve.gov/pubs/feds/2013/201328/201328pap.pdf.
8. See I.R.C. § 1031, no gain or loss is recognized on the exchange of real property held for productive use in a trade or business.
9. See I.R.C. § 1014.
10. See I.R.C. § 2056.
11. See I.R.C. § 1014.
12. See Internal Revenue Bulletin 2018-10.